Fund management in Banking and Insurance

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Lecture-3

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Basel I and II Accord on capital requirement

The prudential norms on income recognition, assets classification and provisioning (IRAC norms) were introduced by The RBI during financial year 1992-93.

The objective of strengthening the bank financial position
The implantation in following sections:

1. Guideline on capital adequacy
2. Prudential norms

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Guideline on capital adequacy

In 1992, RBI decided to introduce a risk assets ratio system for all scheduled commercial banks bank in India . Adopt the framework of BASEL I recommended by Basel committee on banking supervision(BCBS) Later on, the BCBS related to comprehensive version of revised framework in 2006 refer BASEL-II

The Basel –II suggested three Pillar approach:

Pillar I- Minimum capital requirement
Pillar-II- supervisory review process
Pillar-III- Market discipline requirement

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Pilllar-I

Pillar-I (Minimum capital standard)

The banks are required to maintain capital with reference to their risk weighted assets. This kept in the form of capital aqueuacy ratio(CAR) or capital to risk assets ratio(CRAR).

The major risk address by Basel-II to maintain capital fund are:

Credit risk
Market risk
Operational risk

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Pillar-I

The minimum capital funds suggested in Basel-II is 8 per cent. In India, required to maintain capital fund of 9 per cent against risk weighted assets.

Calculation of CAR:

Capital Adequacy Ratio = (Tier1 Capital + Tier2 Capital) / (Risk Weighted Assets)

Tier 1 Capital = Equity Share Capital + Share Premium + General Reserve (unencumbered)+ capital reserves

Tier 2 Capital = Preference Share + Subordinated Debt Bonds + Revaluation Reserves (45%)+ hybrid debt capital structure

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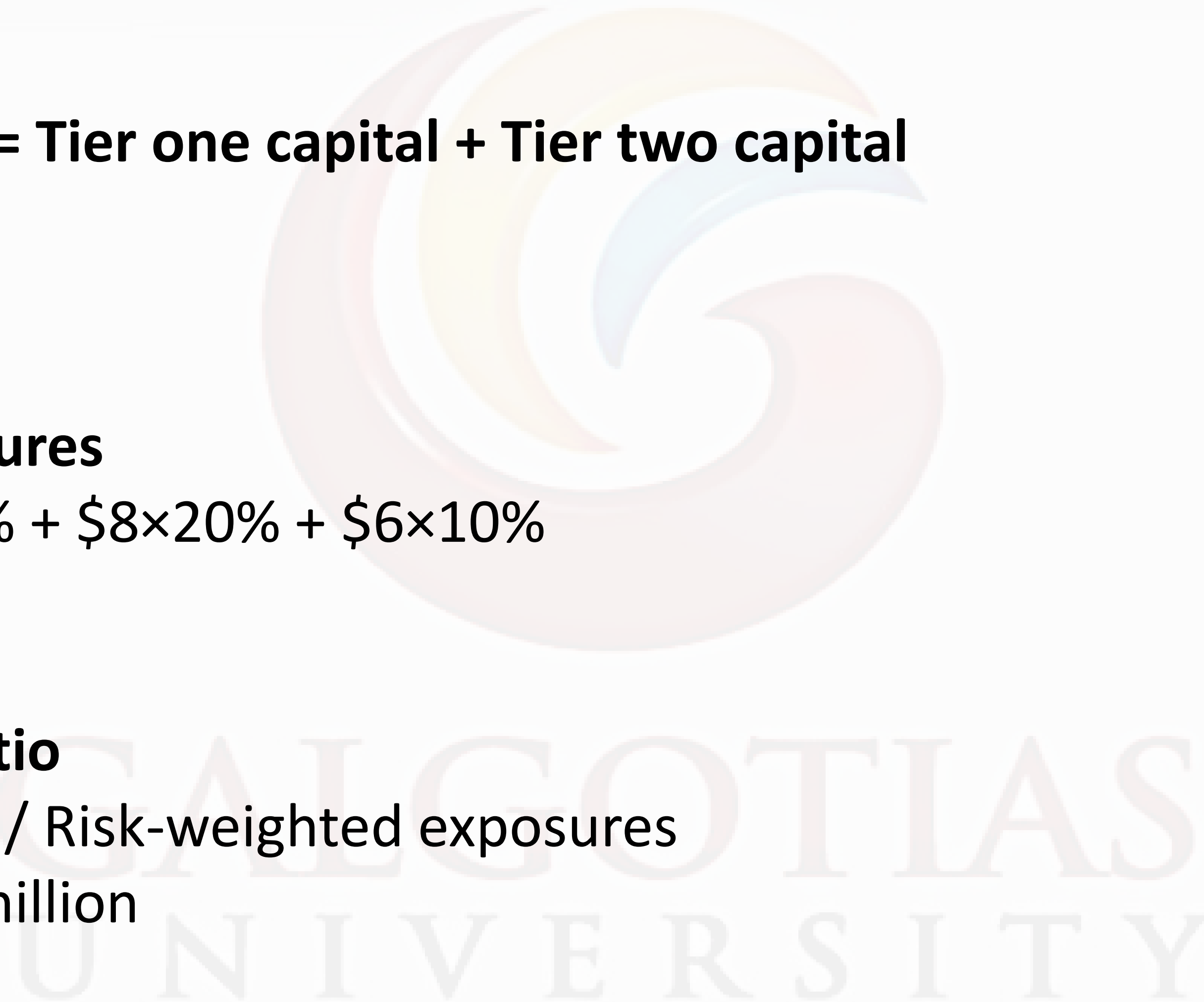
Problem on CAR Calculation

Example

Using the following information. Calculate Capital Adequacy Ratio.

	Exposure	Risk Weight
Government Treasury held as asset	*1,500,000*	*0%*
Loans to Corporates	*15,000,000*	*10%*
Loans to Small Businesses	*8,000,000*	*20%*
Guarantees and other non-balance sheet Exposures	*6,000,000*	*10%*

The bank's Tier 1 Capital and Tier 2 Capital are $200,000 and $300,000 respectively.



Solution

Banks's total capital = Tier one capital + Tier two capital

= 200,000 + 300,000

= $500,000

Risk-weighted exposures

= $1.5×0% + $15×10% + $8×20% + $6×10%

= **$3.7 million**

Capital Adequacy Ratio

= Banks's total capital/ Risk-weighted exposures

= $0.5 million/ $3.7 million

= 14%

Pillar-II

For calculating of risk weighted assets to maintain capital, different approaches have been suggested under Basel-II:

Credit risk calculated by these approach

- Standarized approach
- Internal rating approach

Market risk calculated by these approach

- Standararized approach
- Internal risk approach
- Operational risk can be calculated by using these approaches
- Basic indicator approach
- Standard approach
- Advance measurement approach

2. Prudential norms

1. Norm for income recognition
2. Loans and advances classification
3. Gross and net performing assets
4. Provision for loan assets

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References

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Thank You

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